

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT

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### Overview

This document provides for City Council consideration three alternative forecast scenarios. The “**Base Case**” is considered the most likely projection and that which the Administration recommends be used to formulate the 2006-2007 Proposed Budget. Given the uncertainties inherent in any forecast for a period as long as five years, however, we also provide two alternative case forecasts for the General Fund for the next five years which attempt to model the potential impact of more optimistic and more pessimistic views of the future economic environment.

The Base Case forecast has been built using two basic assumptions: (1) the local economy has stabilized from the severe and sustained slowdown experienced over a four year period beginning in 2000-2001, and has begun to exhibit sustained but modest growth levels, and (2) approximately this current level of growth will continue over the forecast period, with neither a return to the recessionary conditions of the last few years, nor a return to the abnormally high growth levels experienced in the late 1990s. As a result, the Base Case forecast projects sustained but moderate growth in General Fund revenue collections in both the first year of the forecast, and with only small variations, over the remaining four years of the forecast period. The **Optimistic Case**, on the other hand, projects the potential outcome if a more vigorous rate of growth were to develop. This is considered possible only with a significant up-tick in the local business climate, likely led by some new development in the technology world. The **Pessimistic Case**, alternatively, attempts to model the potential outcome of a faltering in the recovery, likely associated with a more severe drop in the local housing market, and a significant decline in the national economy, that leads back to the kind of falloff in business and consumer activity seen in the early 2000s, with associated flattening or drops in General Fund revenues.

As with all forecasts, this one is based on a series of assumptions regarding the overall economic environment, now and in the future. These assumptions were reached after reviewing the projections of a variety of economists and economic forecasts, including the forecasting service to which the City’s consulting economist subscribes (UCLA’s Anderson School of Management Forecast). The forecast for the first year of the period, 2006-2007, updates a preliminary projection provided to Council last November, and will be updated again, as appropriate, as part of the City Manager’s 2006-2007 Proposed Operating Budget, scheduled to be published on May 1, 2006.

The following is a discussion of both the national and local economic outlooks used to develop the revenue estimates upon which the Base Case Forecast is based.

### National Outlook

Our revenue forecast is largely based on the national and State economic forecasts produced by the Anderson School of Management at UCLA and by the expectations of local forecaster Steven Levy, Senior Economist and Director of the Center for the Continuing Study of the California Economy. Both of these sources continue to forecast a modest expansion of the U.S. economy

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### National Outlook (Cont'd.)

for the near-term; with the growth rate gradually decelerating over the next several years.

Currently, the U.S. economy continues to perform relatively well, experiencing 10 straight quarters of above average Gross Domestic Product (GDP) growth through the third quarter of calendar year 2005. Fourth quarter GDP growth, however, fell to a rate of 1.1%, breaking the string of higher than normal growth and, according to various economic reports, either returning us to more normal growth patterns or beginning a new downward trend in growth. Jobs growth at the national level has been steady if not spectacular, generating an estimated two million jobs in calendar year 2005, and consumer spending had another positive year. As the previously roaring U.S. housing market starts slowing, however, our forecast experts believe that associated weakness will appear in the national economy, and that a combination of continued elevated energy prices, higher interest rates, and a cooling of the housing market will lead to weaker economic conditions in the near future. The bottom line is that the UCLA Forecast sees U.S. economic growth slowing somewhat next year.

On the jobs front, the UCLA report forecasts a loss of 500,000 construction jobs and 300,000 jobs in the financial services sector from the housing slowdown, but do not believe that the job losses will spread across many industries. In fact, it is felt that the manufacturing sector jobs are virtually at the floor and there is hardly any room to fall further. This forecast presumes a continued slight pickup in the pace of job growth for the nation as a whole, and very slight growth locally.

Although housing slowdowns have proceeded eight of the last ten recessions in the U.S., the UCLA Forecast predicts that in this case the almost certain softening in the housing market will result in a "soft landing" with a slowdown in overall growth, but not a recession. Although in the past, a major slowdown in housing activity has often been followed by a major loss of jobs in the manufacturing sector, this is less likely under the current conditions. While manufacturing output and overall business spending has been up in the U.S. during the past year, manufacturing employment has inexplicitly remained stagnant. Most economists believe that manufacturing sector employment is virtually at the floor, and there is little room for the sector to fall a lot further. Thus, the consensus projection is that although the slowdown in housing will cause an associated slowdown in the economy, job losses in the manufacturing sector necessary to pull the economy into a recession are not likely. This is not a certainty, however, and the level and impact of a housing market slowdown remains a major concern of many economists and our Budget Office. You do not have to look back too far in the history of our regional and State economy to see why. As Stephen Levy observes, housing prices in California fell and remained at those reduced levels for almost seven years in the 1990s, demonstrating that long periods of slow housing activity are not unusual in California after a big, and ultimately unsustainable market upturn of the sort we may have just experienced occurs.

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### **Santa Clara County/City of San Jose Outlook**

The current economic climate also continues to be a story of two separate economies, the national/State economy and the local economy, particularly in terms of employment. The Nation and the State as a whole have experienced solid if not spectacular job growth. More than two million jobs have been created at the national level, and over 190,000 jobs created at the State level. The Valley economy, by contrast, continues to exhibit stagnant job growth. For example less than 3,000 jobs were created during the most recent twelve months reported (December 2004 through December 2005). The good news is that there are finally solid reasons to believe that the number of jobs has stabilized in the Valley. The bad news is that there remain no indications of a return to any significant levels of job growth necessary to restore the 220,000 jobs lost between 2001 and 2005. This forecast presumes only very modest local job growth over the forecast period.

The general consensus also seems to be that the super hot housing market (some believe it constituted a classic housing price bubble) will deflate instead of pop, with a plateau or only modest drop in home prices, a moderate decrease in sales and new buildings, and weak growth for the next several years. If this scenario occurs, the overall impact to the local economy should be modest. Construction and financial activities will likely take a big hit, but this impact can potentially be balanced out by job growth in other parts of the economy. The Base Case Forecast is based on this premise. If, on the other hand, the slowdown in housing becomes more rapid and severe, the impact on the local economy could be much more serious. A rapidly declining demand for homes, and an especially large drop in home prices would likely heavily impact consumer spending with the high potential to lead the valley back into a slowdown or even a recession.

On the basis of the presumptions described above, therefore, the Base Case Forecast for the local economy is one of cautious optimism, but with relatively modest expectations. Moderate revenue growth is forecast for 2006-2007, even as the housing market continues to cool down as the year progresses. Taxable sales growth will be down slightly from the current levels, but still be positive. Employment will continue to exhibit the painfully slow growth of recent periods.

In terms of the impact of this projection for local economic conditions on City revenue sources, the picture is generally consistent with prior forecasts, and depending on ones level of expectations, generally positive. Those hoping for an imminent return to the roaring economic growth levels of the late 1990s will be disappointed by this forecast. We continue to see those years as aberrations in the longer term state of the local economy, and hold no expectations for a return to those heady times. For those of us with more modest expectations, however, this forecast is a welcome contrast to the painful performance of the recent recession years. This forecast assumes that over the next several years the City will finally see some growth in jobs and modest growth in most City revenues. Some of the higher than anticipated revenue growth being experienced in the current year, however, are expected to slow, as they are tied to some factors that are not likely to be sustained over a very long period. In particular, the extremely strong housing market and the spike in energy costs have led to higher collections in Property Tax, Utility Taxes, and Franchise Fees than we believe sustainable over a multi-year period. The

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### **Santa Clara County/City of San Jose Outlook** (Cont'd.)

cooling housing market and a potential return to more historically normal energy prices would reduce revenue collections significantly in all of those revenue categories.

In summary, therefore, the Base Case Forecast for the General Fund assumes that during the forecast period the City will experience more historical moderate levels of revenue growth. Although this scenario represents a welcome improvement over the rapid declines suffered post 2001, the revenue growth will not begin to match the increases experienced in the years preceding that fall. As explained elsewhere in this forecast document, even these improved revenue growth levels are not sufficient to match the higher expenditure growth levels anticipated during the same period. The unfortunate result is a forecast with smaller but persistent shortfalls in the General Fund in each year of the forecast period.

### **Economic Drivers**

The 2007-2011 Base Case Forecast was built utilizing the following specific economic assumptions:

- The National Real Gross Domestic Product will grow 2.6% in 2006-2007, 2.8% in 2007-2008, 3.0% in both 2008-2009 and 2009-2010, and 3.6% in 2010-2011.
- The prime rate will remain at a relatively moderate level, averaging 6.5% over the forecast period.
- Mortgage rates will remain at relatively stable levels over the period, ranging from 6.8% to 6.9% in each year of the forecast.
- The national unemployment rate will remain relatively low at 5.1% in 2006-2007, 5.2% in 2007-2008 and 5.4% for the last three years of the forecast, averaging 5.3% over the forecast period.
- National employment growth will rise to 1.1% in 2006-2007, and increase slightly in the out years, averaging 1.3% over the period.
- Historically low national inflation rates will rise only slightly, with growth averaging 2.6% over the forecast period, with a high of 3.5% in 2006-2007 and a low of 2.2% in 2007-2008.
- Local inflation rates, which typically track above national levels, will average 3.0% over the forecast period, with a high rate of 3.7% in 2006-2007 and a low rate of 2.5% in 2008-2009.

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### **Economic Drivers** (Cont'd.)

- San José's population growth levels will be modest over the period, with growth of less than 1% annually over the forecast period. Total population is expected to grow from approximately 963,000 residents in 2006-2007 to 994,000 residents in the 2010-2011 based on information from the State Department of Finance.
- The County unemployment rate will remain below the national level, averaging 4.4% over the forecast period, with a high of 4.5% in 2008-2009 and a low of 4.3% in 2006-2007.
- Total County employment growth rates will average 1.6% over the forecast period, increasing slightly throughout the years of the forecast, changing from 1.3% in 2006-2007 to 1.5% in 2007-2008, 1.7% in both 2008-2009 and 2009-2010, and 1.8% in 2010-2011.

### **Optimistic and Pessimistic Scenarios**

As discussed above, all forecasts are burdened with a large degree of uncertainty, which increases going further into the future. As a result, in addition to the Base Case, two alternate, but plausible, revenue forecast scenarios are also presented in this document: a "Pessimistic" and an "Optimistic" case. These alternatives were developed to display the range of possible outcomes over the next five years under varying economic conditions. The Base Case is, however, still considered the most likely outcome. The scenarios presented were created using specific sets of differing economic and political assumptions.

#### ***Optimistic Case***

The Optimistic Case is one in which both the national and the local economies experience a more robust growth rate than envisioned in the Base Case. Most significantly, the local housing market does not experience the slowdown predicted in the Base Case scenario. Low interest rates and inflation keep the housing market going strong. The strength in the housing market directly affects property taxes through higher valuations and indirectly affects sales taxes by creating a feeling of greater wealth resulting in higher consumer confidence and borrowing power. The strong housing market is driven by much lower interest rates coupled with lower inflation rates than those in the Base Case. The lower rates result from a softer approach to raising interest rates than the Federal Reserve currently seems intent on pursuing.

Local employment is also much stronger in this high case than in the Base Case. The impact of the falling dollar on local technology equipment manufacturers is much greater than expected in the Base Case. The generally stronger U.S. economy also causes a greater increase than expected in the demand for high tech equipment. Without the slowdown in the housing market, there is also no significant loss of construction and financial sector jobs. Later in the forecast period, increases in employment are being driven by the natural innovative cycle characteristic of the Valley's businesses. This means much greater than expected investment by venture capital, more startups and consequently more hiring.

# ELEMENTS OF THE GENERAL FUND FORECAST

## ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)

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### Optimistic and Pessimistic Scenarios (Cont'd.)

#### *Optimistic Case* (Cont'd.)

Sales taxes and property taxes are the biggest winners in this scenario. Sales taxes are over 6% higher than the Base Case in the final year of the forecast. Property taxes are also over 5% higher.

#### *Pessimistic Case*

The conditions in the Pessimistic Case are more or less the opposite of those in the Optimistic Case. In this scenario, interest rates are much higher. The price of oil skyrockets to \$100 per barrel and remains there for a significant period. The very high oil prices lower domestic consumption and increase inflation. To fight inflation, the Federal Reserve keeps steady upward pressure on interest rates. It is also possible that the falling dollar causes rates to rise even more than expected. The national budget deficit also could increase much more than expected in the Base Case causing a substantial rise in interest rates as U.S. borrowing needs edge up ever higher.

The local housing market is hit hard by rising interest rates. In turn, both home prices and resale activity decline sharply. As home prices fall, consumers' ability to borrow in the home equity markets weakens, causing consumers to feel less wealthy and resulting in much lower consumer confidence.

Local employment also falls in each year of this scenario. Lower local employment results from decreased demand for high tech goods at the national level and a lack of any significant innovation from the Valley's businesses. In addition, substantial jobs are lost in the construction and financial sector due to the significant slowdown in the housing market. The Base Case forecasts a relatively low rate of employment growth over the forecast horizon so it would not take much to have that growth rate turn negative as envisioned in this Pessimistic Case. Lower job growth could also result from higher than expected merger activity, off-shoring and increasing State budget deficits which could negatively affect local government employment.

In this Pessimistic Case, both Sales and Property Taxes fall sharply as falling home prices reduce assessed property values and falling consumer confidence reduces consumer spending. With a high debt load already burdening consumers, less borrowing power available from home equity loans, and the lower employment, consumer spending will fall sharply. Without a growing economy, the business-to-business investments would not be enough to offset the decline in consumer spending and the outcome would be yet another economic downturn.

By the end of the forecast period, Sales Tax collections are almost 10% below the Base Case while property taxes are nearly 13% below the Base Case projection. An interesting side affect in this scenario is that the City could actually experience an increase in Utility and Franchise revenues in this scenario if the prediction for higher oil prices drives up energy prices in general.

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## **ASSUMPTIONS REGARDING THE ECONOMIC ENVIRONMENT (CONT'D.)**

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### **Impact of Forecasted Economic Conditions on Revenue Collections**

The economic conditions discussed above are the primary drivers for approximately half of the City's General Fund revenues, with the most significant impacts in the Sales Tax and Property Tax categories. The remaining areas, while impacted by overall economic performance, are primarily driven by other factors. For example, the Utility Tax and Franchise Fee categories are much more heavily impacted by utility rate changes and energy prices than economic growth. Collections in the Fines, Forfeitures, and Penalties category remain relatively flat under all economic conditions, while collections from local, State, and federal agencies are primarily driven by the grant and reimbursement funding available from these agencies. In the cost-recovery fees and charges programs, revenue collections must be directly linked to costs with the result that the General Fund experiences no net gain or loss in times of an economic expansion or slowdown, respectively. Because these revenue sources do not track directly with the performance of the economy, the growth in these areas, even in times of economic strength, can hold down the City's overall revenue growth. Conversely, in an economic slowdown, these categories can act as a buffer, easing the impact of drops in the economically sensitive categories.

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## REVENUE FORECAST

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The specifics of the **Base Case** five-year revenue forecast for the period 2006-2007 through 2010-2011 are presented in Section Two of this report. Consistent with past forecast methodologies, the first year of the revenue forecast (2006-2007) was prepared in a manner similar to the preparation of the base budget revenue estimates. Over 400 revenue sources were examined in detail to estimate the outcome in 2005-2006 and, building upon those projections, revenue estimates for 2006-2007 were developed. These revenue estimates will be examined and updated again during the development of the 2006-2007 Proposed Operating Budget.

As displayed in the forecast, revenues (exclusive of Beginning Fund Balance) are shown to increase from \$709.7 million in 2006-2007 to \$804.6 million in 2010-2011, for an average growth rate of 3.19% per year. This growth rate is slightly higher than that projected in the last forecast presented in February 2005 (3.15%).

Understanding the basis for the revenue estimates included in this forecast requires discussion of the assumptions used for estimating each of the revenue categories. The following discussion focuses on estimates used for the 2006-2007 Base Case.

**Property Tax** receipts of \$163.5 million are projected for 2005-2006. This estimate includes the affect of State budget balancing actions that resulted in an \$11.1 million decrease to the Property Tax category (which impacts both 2004-2005 and 2005-2006) as reported in Monthly Financial Reports (MFRs). Property Tax collections for 2005-2006 are also being heavily influenced by an external factor: the impact of the State Motor Vehicle In-Lieu (VLF) Swap. The “Swap” involved the permanent conversion of VLF backfill funds to Property Tax as part of an approved State budget balancing strategy. Because of the ongoing nature of this change, the compensating State revenue is now treated as Property Tax in this and future years. Recent disbursements received from the State appear to indicate that the “Swap” and its accompanying 2004-2005 “true-up” to actual VLF receipts have resulted in higher than anticipated Property Tax receipts totaling \$10.2 million in 2005-2006. Excluding the impact of those two adjustments, projected receipts for 2005-2006 represent growth of approximately 8.5% over the prior year, reflecting higher growth in the Secured category, offset by decreases in the Unsecured Property Tax and SB 813 (property resales) collection areas. In 2006-2007, Property Tax collections are projected to increase 11.6% over the 2005-2006 estimate to a total collection level of \$182.4 million. Anticipated performance in each of the Property Tax sub-categories is discussed below.

Secured Property Taxes account for approximately 90% of the revenues in this category. In 2006-2007, Secured Property Tax growth will be driven by annual growth in the property tax roll and an adjustment associated with State budget actions. The 2006-2007 Secured Property Tax levy will be based on real estate activity in calendar year 2005. Performance in 2005, while still extremely strong, started to slow down at the end of the year with a reduction in the number of property transfers and a leveling off of home prices. Secured Property Tax roll growth of 8.0% is projected for 2006-2007 based on very preliminary information from the County of Santa Clara and recent activity trends. At this point, final data on the actual tax levy for 2006-2007 is not available as adjustments are made through July 1, 2006. Updated information on the growth in the tax role should be available for the development of the 2006-2007 Proposed Operating Budget, which will allow for further refinement of the growth estimate in this category. The



# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### **Property Tax** (Cont'd.)

Secured Property Tax category will also increase in 2006-2007 due to the return of the \$11.1 million that had been redirected as a State budget balancing action for the last two years, as mentioned above. Overall, the Secured Property Tax category is expected to increase 13.9% in 2006-2007 to a total collection level of \$166.3 million.

Current and Prior Unsecured Taxes are the second largest revenue source in this category. Growth in this category is driven primarily by increases in the value of personal property (e.g., equipment and machinery used by business and industry for manufacturing and production) and is usually characterized by a time lag impacting actual collections. During the last decade, performance in this category has been extremely volatile, with annual growth or declines reaching double-digit levels based primarily on the strength of the local business sector. Collections in this category have been going down in recent years as a result of the economic downturn. While Unsecured Property Tax collections are expected to start leveling off, declines of 3.9% in 2005-2006 and an additional 2.0% in 2006-2007 are still projected. This would bring the estimate to \$10.2 million in 2006-2007. It should be noted that this forecast assumes that the County Assessor will not be taking any actions to significantly change the depreciation schedules used to value major business equipment items.

SB 813 Property Taxes (supplemental taxes) represent payments for taxes owed on recent housing resales. Based on the latest information from the County of Santa Clara, a decline of 11.0% is projected for 2005-2006. This decline reflects the start of the slowdown in the housing market that began at the end of calendar year 2005 and is expected to continue into 2006-2007. As a result, a larger decline of 20.0% is projected for 2006-2007, bringing the total collection level to \$4.6 million. This level of decline is in line with the decline experienced in 2002-2003 (22.3%) that occurred before the last three years of the unsustainably strong market environment. All other property taxes (Homeowners Property Tax Relief and Agricultural Tax Relief) are assumed to have little or no growth in 2006-2007, consistent with historical trends.

Through the remaining years of the forecast, Property Tax collections are expected to increase by an average of 5.4% per year, with growth ranging from 5.77% in 2007-2008 to 5.07% in 2010-2011. These growth rates, while below those experienced in recent years, reflect what is believed to be a more sustainable level of activity.

The projection for 2005-2006 year-end collections of **Sales Taxes** is a key factor in determining the Sales Tax forecast for 2006-2007 and each year thereafter. The forecast for the General Sales Tax revenue estimate assumes an increase of approximately 5.0% in 2005-2006 over the actual prior year collection level. The 2005-2006 estimate is built on the actual performance for the first quarter (July through September activity) and estimates for the remaining three quarters. The first quarter was up a surprising 14.5%. However, as explained in prior MFRs, information from our Sales Tax consultants indicates that a significant portion of this increase was actually the result of an error at the State Board of Equalization (SBE) that caused some sales tax returns that should have been processed in the previous quarter to be processed in this quarter instead. Taking this adjustment into account, along with adjustments for other one-time

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## REVENUE FORECAST (CONT'D.)

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### **Sales Tax** (Cont'd.)

transactions, our consultants calculate that the recent quarterly Sales Tax receipts would represent positive growth approximating 8.1% on an economic basis. While this performance is encouraging, the analysis by our tax consultants also indicates that a large part of the increase was due to one-time incentives for auto sales and the spike in gas prices, as well as higher than anticipated construction activity during that quarter. After analyzing these receipts in detail, our Sales Tax consultants, MBIA MuniServices, believe that a reasonable expectation for Sales Tax receipts for the remaining three quarters of the year would be in the range of 2.0% to 3.0%, which still compares favorably with the budgeted growth expectation included in the 2005-2006 Adopted Budget estimate. Based on this information this forecast projects a 2.0% increase for the remaining three quarters of the year, which when combined with the first quarter receipts results in an overall increase of 5.0%.

The 2006-2007 General Sales Tax estimate of \$139.6 million assumes growth of 3.0% over the 2005-2006 estimated collection level, reflecting a presumed impact of the softening housing market on consumer spending, offset somewhat by modest improvements in business-to-business Sales Tax collections.

Proposition 172 Sales Tax collections (representing the one-half cent tax that is allocated to counties and cities on an ongoing basis for the use in funding public safety programs) are expected to total \$4.3 million in 2005-2006, which is the same collection level experienced in 2004-2005. In 2005-2006, modest growth of 2.3% is anticipated. Collections in this category are based on both the actual State-wide sales tax receipts and the relative sales tax performance of Santa Clara County to the State. In the past, Santa Clara County has outperformed the State in sales tax receipts and, thus, has received a growing portion of the Proposition 172 Sales Tax revenues. This has not been the case in recent years as Silicon Valley was disproportionately impacted by the economic downturn in the early part of this decade. Modest growth in this category is expected to resume with the improved sales tax performance in this region and overall growth for the State.

Through the remaining years of the forecast in the Sales Tax category, the growth rate averages 3.8%. These rates range from a low of 3.6% in 2010-2011 to a high of 4.03% in 2007-2008.

The **Departmental Charges** and **Other Licenses** categories contain fees and charges imposed by various departments within the City. The most significant revenue sources are from the collection of construction and development-related fees. Revenue collection levels are projected based on City Council-approved cost-recovery policies with the goal of a net-zero impact on the General Fund. When developing the forecast estimates for these categories, the revenues are set at the anticipated collection levels. In cases where the revenues are projected to exceed costs, the impacted departments will need to develop budget proposals for incorporation into the Proposed Operating Budget to increase resources to meet the service demands or to reduce fees. On the other hand, if the projected revenues are not sufficient to cover the base costs, departments will be submitting proposals to reduce costs and/or increase fees to bring projected revenues and expenditures back in line for a net-zero General Fund impact.

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## REVENUE FORECAST (CONT'D.)

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### **Departmental Charges and Other Licenses** (Cont'd.)

Both the Departmental Charges and Other Licenses categories are expected to experience growth over the forecast period based on the most recent activity trends. For the Departmental Charges category, this growth ranges from 3.49% to 3.92% annually for each of the out years of the forecast. For the Other Licenses category, the growth rates range from 3.99% to 4.28% annually.

**Business License Taxes** are projected in two categories: General Business License Tax and Disposal Facility Tax. The 2005-2006 estimate for General Business License Tax proceeds are expected to fall below the Adopted Budget estimate of \$14.0 million, reflecting lower than budgeted collections of one-time regulatory enforcement revenue and revenue from the Business Tax amnesty program. Although year-end receipts of \$12.8 million are projected to fall \$1.2 million below the Adopted Budget estimate, this level of collection would still represent an increase of 4.9% from prior year collections of \$12.2 million. For 2006-2007, with the end of the amnesty program, revenues are expected to decline by 6.3% to \$12.0 million. In the Disposal Facility Tax (DFT) category, revenue collections in 2005-2006 are expected to fall below the Adopted Budget estimate (\$14.3 million) by approximately \$1.3 million, declining to \$13.0 million. This reduction is entirely due to the settlement of the dispute over the removal of the Alternate Daily Cover (ADC) exemption reported in MFRs and last year's forecast that resulted in the City agreeing to reinstate the Alternate Daily Cover (ADC) exemption and allow a credit to the haulers for amounts that had been paid to the City due to the removal of the exemption. Without this credit, 2005-2006 collections would have met, or possibly slightly exceeded the Adopted Budget Estimate. Taking the above into account, the \$14.7 million projected for 2006-2007 represents a slight increase of 2.8% over the 2005-2006 Adopted Budget estimate of \$14.3 million. In the remaining years of the forecast, growth in the Business License Taxes category is expected to experience very minimal growth averaging only 0.27% per year.

The **Money and Property** category consists primarily of interest income. The 2006-2007 estimates in this forecast for earnings on investments of General Fund and several other funds' cash assume an average interest rate of 3.5%, applied to an average cash balance of approximately \$191.0 million for a total collection level of \$6.7 million. This forecast reflects a slight increase to the average interest rate yield (up from 3.0% in 2005-2006) and a decrease in the average cash balance (down from \$199.8 million), used to develop the projection for 2005-2006. Interest transfers from capital and special funds have been adjusted to reflect the various impacts of expected activity and fund balance levels in 2006-2007. These sources are expected to generate \$3.8 million in 2006-2007. The forecast projects modest declines of approximately 2.5% in the out years based on an anticipated drop in the average cash balance.

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### REVENUE FORECAST (CONT'D.)

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A decline of 15.0% in **Motor Vehicle In-Lieu** fees is assumed for 2005-2006. The majority of the decline is due to the impact of the VLF “Swap” mentioned in the Property Tax Category above. As explained in prior MFRs and last year’s Forecast document, the VLF “Swap” involved the permanent conversion of VLF backfill funds to Property Tax as part of an approved State budget balancing strategy, reducing this revenue category from what had once been a \$50 million revenue source to a \$5 million revenue source. The VLF “Swap” was implemented in the middle of the third month of 2004-2005, resulting in 2.5 months of backfill being collected in that year. Taking this amount into account, revenue collections in this category were actually relatively flat in 2005-2006. Slight growth of 2.0% is included in this Forecast for 2006-2007, bringing projected revenues to \$5.2 million. In the out years of the forecast, small annual increases ranging from 2.4% to 2.7% are anticipated.

**Federal Revenue** and **Other State Revenue** categories consist primarily of grant revenues. For 2005-2006 and 2006-2007 the ongoing San José LEARNS grant of approximately \$1.7 million is included in the forecast. For 2006-2007, Public Library Foundation funding is currently projected at \$316,000, a reduction from the 2005-2006 estimated level of \$344,000. The Abandoned Vehicles Abatement Program funding from the State is estimated to be \$710,000 in 2006-2007, which is consistent with the current year estimate. Other ongoing revenues are projected to be received approximately at the current year level for 2006-2007 and are estimated to be relatively flat over the remaining years of the forecast.

The estimate for **Gas Taxes** assumes that collections in 2005-2006 will total \$17.5 million and that the high price increases in gasoline will cause slightly lower consumption resulting in a slight reduction to \$17.0 million in 2006-2007. In the out years of the forecast, average growth of just over 1.0% annually is projected, with growth rates ranging from flat growth in 2010-2011 to a 2.1% increase in 2009-2010.

The **Transient Occupancy Tax** estimate for 2005-2006 reflects robust growth of 9.2% from the prior year level, primarily as a result of the increase in occupancy rates. In 2006-2007, continued modest growth of 7.1% is anticipated. In the remaining years of the forecast, average annual growth of approximately 5.5% is projected based on a combination of anticipated increases in both occupancy rates and room rates along with a slight increase in the number of rooms available.

**Utility Taxes** are imposed on electricity, gas, water, and telephone usage. Collections in 2005-2006 are anticipated to end the year 4.7% above the 2004-2005 actual level. This performance primarily reflects the impacts from the disastrous hurricane season, and other factors that caused natural gas costs to increase significantly during the short-term that are expected to result in significantly higher (25.0%) collections of Gas Utility Taxes in 2005-2006 when compared to collections received in 2004-2005. The impact of the increase in natural gas prices is expected to be one-time in nature and has been born out by declines in this area that have already started to occur. As a result, the estimate for 2006-2007 of \$9.7 million assumes a 4.0% increase on a base calculated by increasing 2004-2005 actual collections by 2.0% to take out the affect of the one-time spike in natural gas prices. Electricity Utility Taxes are expected to experience flat growth

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## REVENUE FORECAST (CONT'D.)

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### Utility Taxes (Cont'd.)

In 2005-2006 and an increase of 2.2% in 2006-2007, due mainly to a 2.2% average price increase granted to Pacific Gas and Electric Company by the Public Utilities Commission that started in January 2006. In the Telephone Utility Tax category, collections in 2005-2006 are expected to exceed the prior year level by 4.4%. Performance in this category has been impacted by the way customers access telephone service. The trend has been for a slight decline in the revenues associated with landlines that are more than offset by the continued strong growth in cellular phone usage. The 3.1% increase in Telephone Utility Tax in 2006-2007 assumes a net 0.5% decrease in landlines and 5.0% increase in cell phone usage. For the Water Utility Tax area, growth of 4.0% is expected in 2005-2006 with an additional 2.0% increase anticipated in 2006-2007. The growth in 2006-2007 is based on an expected rate increase, partially offset by lower consumption rates. In the out years of the forecast, overall Utility Tax growth ranging from a low of 2.0% in 2009-2010 to a high of 4.0% in 2008-2009 is anticipated.

In the current year, **Franchise Fee** collections are expected to increase by approximately 5.5% from the 2004-2005 actual level. The increase from the prior year mainly reflects an increase in Commercial Solid Waste (CSW) Franchise Fees. In the CSW Franchise Fee category, collections are anticipated to grow by 8.2% in 2005-2006, due partly to a slight (\$0.15/yd) fee increase and an increase in business activity. In 2006-2007, CSW Franchise Fees are expected to remain fairly flat due to changes to the commercial system that are anticipated to increase recycling and also enhance fee collections, resulting in a net flat collections of CSW Franchise Fees of \$11.6 million.

In 2006-2007, the projection for collections in the Electricity and Gas Franchise Fee categories will be based on activity from calendar year 2006. For the Electricity Franchise Fee, modest growth of 2.7% is anticipated based on relatively stable rates for Electricity. In the Gas Franchise Fee area, high growth of 13.6% is estimated for 2006-2007 to reflect the one-time spike in natural gas prices mentioned above that occurred in the early months of 2006. In 2006-2007, receipts would total \$13.7 million for Electrical Franchise Fees and \$9.7 million for Gas Franchise Fees.

Cable Franchise fees are conservatively estimated to increase 2.0% in 2006-2007 based on the most recent activity trends to a total collection level of \$4.8 million. (The City is still in negotiations with the cable television provider.) Nitrogen Gas Pipeline Franchise Fees of \$58,000 are expected to remain flat and Water Franchise Fees are expected to grow by approximately 1.8% to \$224,000. City Generated Tow Franchise Fees for 2006-2007 are expected to remain flat from the 2005-2006 estimate of \$1.2 million.

In the out years of the forecast, revenues are anticipated to increase an average of 3.0% annually. This growth assumption reflects slight increases in water, gas, and electricity rates and a small increase in consumption.

## ELEMENTS OF THE GENERAL FUND FORECAST

### REVENUE FORECAST (CONT'D.)

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The 2005-2006 estimates for the **Fines, Forfeitures and Penalties** category presume a slight (1.6%) decline from the 2004-2005 actual collection levels. It is assumed that collections in 2006-2007 will decline an additional 6.1% compared to 2005-2006 year-end projections, reaching \$12.4 million. The decline in Business Tax penalties is one of the primary causes for the lower collection rate. Collections in this category have been extremely strong in recent years as a result of programs designed to maximize Business Tax collections. With a greater number of businesses now in compliance, the Business Tax penalties category is now expected to decline. In the out years of the forecast, growth of slightly more than 1% annually for this category is anticipated.

As with the prior forecasts, the long delayed collection of the Garden City penalty payment (\$582,900) is not included in this forecast. While three full penalty payments are still due from Garden City, it is not known when or if these payments will be made due to Garden City's continued involvement in bankruptcy proceedings. The scheduled payments have not been received for the last seven years.

The largest portion of the **Revenue from Local Agencies** category consists of Redevelopment Agency Convention Center lease payment (pass-through) reimbursements. The debt service amounts have been predetermined. Estimated Agency reimbursements for City service costs for 2006-2007 are based on the assumption that ongoing support will remain consistent with current levels and that no State action will impact this reimbursement-related revenue source. Redevelopment Agency reimbursements for past capital expenditures (which enable the City to fund the San José Best Program - \$3.0 million) have also been included in the forecast, again presuming no disruption from State budget actions.

For 2005-2006, Central Fire District payments are expected to end the year at \$5.6 million, exceeding the budgeted amount of \$5.0 million, primarily due to one-time receipts of a true-up payment related to the prior year. Property taxes fund the Central Fire District activities, and those payments for the County areas covered by the San José Fire Department are passed on to the City. Based on information from the County related to this particular revenue source, growth of 8.0% is projected for 2006-2007, after adjusting for the one-time receipts just mentioned, to reflect the anticipated increase in Secured Property Tax revenues. Enterprise Fund In-Lieu payments, representing revenue from the Water Pollution Control Plant and Municipal Water System in lieu of taxes, are expected to increase by a net 3.8% in 2006-2007 to \$4.2 million, due to the combination of higher property values at the Water Pollution Control Plant, and rate and consumption increases anticipated for the Municipal Water System.

Also in 2006-2007, payments from the County of Santa Clara for the first responder advanced life support program (Paramedic Program) are assumed to be flat at \$1.6 million as the receipts are based on the annual adjustments approved by a contract that is currently under negotiation.

An overall growth of 3.2% from the 2005-2006 year-end estimate is expected in the Revenue from Local Agencies category in 2006-2007. Overall, the average growth rate following 2006-2007 is approximately 1.5%.

## ELEMENTS OF THE GENERAL FUND FORECAST

### REVENUE FORECAST (CONT'D.)

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The **Other Revenue** category consists of miscellaneous revenues received from a variety of sources, including proceeds from the Sale of Surplus Property, cost reimbursements for the Investment Program, Arena Rental, Suite, Parking, and Naming revenues, and reimbursements from the Airport to cover the FMC property debt service payments. Revenue estimates assume continuation of current year activity levels with revisions, where appropriate for 2006-2007 costs or agreements, with the exception of the Arena revenues. Arena revenues are projected to total \$3.6 million in 2006-2007. This amount is approximately \$700,000 below the level that would have been anticipated had the National Hockey League (NHL) not experienced a lockout that resulted in the cancellation of the entire current hockey season in 2004-2005. Under the agreement with San José Arena Management (SJAM), arena payments are calculated, in part, based on hockey revenue that uses the past two years as the basis for the calculation. As a result, the loss of revenue resulting from the cancellation of the 2004-2005 season impacts collections in both 2005-2006 and 2006-2007.

Proceeds from the Sale of Surplus Property category has been set at \$100,000 to assume that, at a minimum, the costs of the Real Estate Division related to the sales process will be recovered.

The **Overhead Reimbursements** category includes overhead reimbursements from both operating and capital funds. While the 2006-2007 overhead rates are not yet available, preliminary projections have been included in this forecast totaling \$29.0 million based on the existing overhead rates with adjustments for estimated salary increases to positions for which an overhead rate is applied, increases in central costs for which overhead is applied such as the maintenance of the new City Hall, and a projected decrease in the Airport overhead rate. It is anticipated that updated projections will be incorporated into the 2006-2007 Proposed Operating Budget based on the actual 2006-2007 overhead rates. In the remaining years of the forecast, an overall average increase of approximately 3.0% is assumed annually reflecting the anticipated cost of living adjustments.

The **Reimbursements for Services** category reimburses the City for actual costs associated with the Deferred Compensation Program and the Maintenance Assessment District Funds. These amounts have been set to recover costs in 2006-2007, with average increases of approximately 3% in the out years of the forecast to reflect anticipated cost of living adjustments.

A 53.4% overall decrease in the **Transfers** category estimate for 2006-2007 reflects reductions for the elimination of one-time transfers included in the 2005-2006 budget, plus a significant presumed impact of a sunseting of the Emergency Communication System Support (ECSS) Fee. This fee, which generates approximately \$19.8 million annually, is currently slated to sunset in the middle of 2006-2007 unless Council action is taken to renew the fee. Thus the 2006-2007 forecast presumes that only a half a year of fee collections (\$9.9 million), with the elimination of elimination of the fee altogether in 2007-2008. Obviously, the impact of retaining or losing the annual proceeds from this fee of almost \$20 million will have an enormous impact on the budget situations facing the City's General Fund in future years.

# ELEMENTS OF THE GENERAL FUND FORECAST

## REVENUE FORECAST (CONT'D.)

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### Transfers (Cont'd.)

Also in this category, a cost of living increase in the reimbursement for Airport Crash Fire Rescue and Airport Police Consolidation costs is assumed for 2006-2007 and the remaining four years of the forecast. The remaining transfers have been reflected at current year levels, with slight adjustments for costs or payment schedules as necessary.

The forecast estimate for available **Beginning Fund Balance** in 2006-2007 of \$57.2 million is based on the following assumptions:

- A Contingency Reserve balance of at least \$24.2 million will remain uncommitted by year-end; and
- A total of \$33.0 million will be achieved from a combination of revenue and expenditure savings and the liquidation of prior-year carryover encumbrances. This higher than prior year projected levels represents the surplus in revenue collections being experienced so far in the 2005-2006 fiscal year, as described in Monthly Financial Report documents for the last several months.

The future year beginning fund balance estimates assume a more historically normal and lower (\$18.0 million) level for the unrestricted portion of the balance. The carried over Contingency Reserve portion is adjusted upward each year to reflect the amounts necessary to comply with the Council policy that the Contingency Reserve be maintained at least at the 3.0% of expenditures level.



# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST

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### Personal Services Base

As is our usual practice, the first year (2006-2007) projection for personal services costs has been calculated at a detailed level. An extract of payroll system information as of September 2005 was used as the starting point. This individual position-level information was then reviewed, corrected, and updated by each department to include current vacancies and filled positions, accurate salary step status, as well as any position reclassifications. In addition, 2005-2006 ongoing position reductions and additions were annualized, and projections for all categories of benefit costs in the coming year were made. Funding for projected but not yet finalized bargaining unit agreements is carried in a separate earmarked Salary and Benefit Reserve.

The resulting 2006-2007 personal services preliminary estimate, as displayed in Section Two of this report, represents growth of approximately 7.3% from the 2005-2006 Adopted Budget level. The growth of approximately \$37.5 million results from the combined impact of a number of factors:

- Salary and benefit growth from negotiated agreements to be implemented in the current year (2005-2006), but not distributed in the 2005-2006 Adopted Budget (ten of thirteen employee groups);
- Second year salary and benefit costs for nine of thirteen employee groups;
- An increase of approximately 16% (\$5.0 million) for the City's lowest priced health plan effective January 2006;
- Transfer of Animal Care and Services Program from the City-Wide Expenditures category to Parks, Recreation and Neighborhood Services Department's Personal Services (\$4.9 million). With the completion of the new Animal Care Center, the City has all elements of animal care and services in its direct control; and
- An increase of approximately \$9.1 million in the General Fund for the City's contribution for both the Federated and Police/Fire Retirement plans. The Federated and Police/Fire retirement costs reflect the change in the employer contribution rates from 17.12% to 21.98% (Federated) and 25.04% to 25.61% (Police/Fire) as applied to base salaries. It should be noted, however, that the February 2005 forecast had assumed a much greater increase to the Police/Fire Retirement plan's rate for 2006-2007 based on preliminary estimates provided by the Retirement Board's actuarial firm. As a result, a reduction to expenditures totaling approximately \$25.9 million has been reflected in this forecast when compared to the costs provided in the prior forecast document.

It should be noted that the level of growth shown for departmental personal services costs in the forecast actually understates the total personal services growth projected for 2006-2007 because costs for four of the thirteen employee groups are not included in the personal services total. The four groups not included are the International Association of Firefighters (IAFF), the International Union of Operating Engineers (OE3), Unrepresented Non-Management (Unit 8) and Executive Management (Unit 99). In the case of IAFF, no compensation adjustments have been reflected since their contract expired February 29, 2004 and labor negotiations continue to be ongoing. In addition, a portion of the Police Officers Association's (POA) Memorandum of Agreement for 2006-2007 included a retirement benefit enhancement which has not yet resulted

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Personal Services Base** (Cont'd.)

in an approved retirement rate by the Police/Fire Retirement Board, and therefore, is not reflected here. The projected salary and benefit cost increases for these four employee groups as well as estimated retirement cost increases for the POA retirement enhancement are carried separately in the Salary and Benefit Reserve.

It should also be noted that due to the mechanism used to represent the desired outcome in fee programs, personal services expenditures in this forecast are further understated by approximately \$1.5 million. The \$1.5 million represents the shortfall that would exist in the development-related fee programs in the Public Works and Planning, Building and Code Enforcement Departments if all costs were reflected. These fee programs are intended by the City Council to recover 100% of the cost of development review and inspection and, as a result, costs are reflected in this forecast at the expected revenue collection level. Each of the fee programs will be required to develop strategies that will address this \$1.5 million shortfall in the 2006-2007 Proposed Operating Budget process.

As with past forecasts, personal services costs in years two through five of the forecast have been projected on a more global basis, using the detailed costs calculated for the first year as a base, and then growing that base by an overall percentage factor representing expected growth from salary and benefit adjustments. For this forecast, the out years were projected to inflate at a composite rate of approximately 5.6%. This projected rate of growth is down from the 6.5% presumed in the February 2005 forecast due to refinements in the forecast model for turnover and salary assumptions.

### **Non-Personal/Equipment Base**

Non-personal/equipment expenditures for the first year of the forecast have also been calculated at a detailed level. The process utilized by the Budget Office includes adjusting each department's current year budget to eliminate one-time allocations, annualizing all partial-year reductions or additions approved for 2005-2006, and including projected adjustments for specific large non-personal/equipment allocations (e.g., utilities, leases, contracted services and Police Department vehicle replacement) as described later in greater detail. The resulting 2006-2007 estimates represent an increase (\$2.4 million) from the current year level. This reflects the net impact of deleting one-time additions and rebudgeted items included in the 2005-2006 Adopted Budget and the transfer of the Animal Care and Services Program from City-Wide Expenditures to Parks, Recreation and Neighborhood Services Department's Non-Personal/Equipment (\$.8 million).

Departmental gas and electricity funding for 2006-2007 has been increased in this forecast by \$856,000 to reflect approved gas and electricity rates, and projected consumption changes from expanded City facilities. Other specific adjustments included in the 2006-2007 non-personal/equipment base include increases for vehicle maintenance and operating costs (\$601,000) and contractually required cost of living increases to major contracts. For the out years of the forecast, a growth rate of 2.0% has been assumed from the 2006-2007 non-personal/

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### **Non-Personal/Equipment Base** (Cont'd.)

equipment base level in each of the four years. This projection is unchanged from that assumed in recent forecasts.

In 2006-2007, \$1.5 million is included for lease payment requirements necessary to support remaining City operations located in leased space after the move of many City operations previously located in leased space to the New City Hall.

### **Other Expenditures**

The **City-Wide Expenses** program in the first year of the forecast (2006-2007) represents a net reduction of \$21.4 million from the 2005-2006 level. This large reduction reflects the combined impact of deleting rebudgets (\$36.4 million) and other one-time items (\$.5 million) budgeted in 2005-2006; and the transfer of the Animal Care and Services Program (\$5.7 million) to Personal Services and Non-Personal/Equipment. This overall reduction is partially offset, however, by the inclusion of costs related to the Grand Prix Race that was recently approved by City Council (\$.8 million in 2006-2007, reduced to \$.3 million in the remaining years); the annualization of debt service payments for the New City Hall and Garage (\$12.2 million increase); FMC property acquisition debt service payments, which are offset by additional Airport reimbursements (\$2.1 million increase); and debt service for the Furniture, Technology and Equipment commercial paper allocation (\$5.6 million per year, increase of \$446,000). With a seven-year repayment schedule, the furniture, technology and equipment obligation will expire shortly after the forecast period. Workers' Compensation Claims payments in this forecast range from \$17.0 million in 2006-2007 to \$21.7 million in 2010-2011. The five-year total is a reduction from the previous forecast, reflecting the implementation of new State Workers' Compensation reform laws that have increased benefits while reducing costs, but an increase of \$1.5 million over 2005-2006.

The **Other Transfers** category includes funding for Communications Center debt service as required under the terms of financing used for construction of this facility (\$2.379 million in 2006-2007) and funding to cover a portion of the debt service payments for the Rancho del Pueblo and Los Lagos Golf Courses (\$1.25 million per year). All of the debt service and maintenance and operations costs for these two facilities are funded in the Municipal Golf Course Fund, however revenues in that fund are not projected to be sufficient to totally cover all of these golf course costs. In addition, revenue-offset payments for the Camden Lifetime Activities Center debt service (\$217,000 in 2006-2007) and various Maintenance Assessment Districts for the General Fund's share of landscape services in those areas are included.

The General Fund **Capital Projects** category includes \$759,000 for the Congestion Management program and debt service payments for Central Service Yard – Phase I (\$1.7 million per year). Also included in this category is the continuation of allocations for Arena Repairs, unanticipated maintenance of City facilities, fuel tanks, and methane monitoring, control and replacement.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Other Expenditures (Cont'd.)

As was the case in previous forecasts, continued capital funding for the **Replacement of Fire Apparatus** is carried in this forecast. In 2006-2007, the level of funding is \$1.7 million and increases to \$2.2 million in 2010-2011 to fund the current Fire Vehicle Replacement Policy.

**Fire Apparatus Lease and Fire Truck/Engines Bond** - Ongoing capital allocations are included under terms of the lease agreement approved in the 1996-1997 Adopted Budget and a bond issue approved as part of the 1997-1998 Adopted Budget, which combined would be used to acquire replacements for 15 fire engines, three aerial ladder trucks and three brush patrol units. The final payment of \$284,000 is scheduled in 2006-2007.

**A Sidewalk Repair Program Capital Allocation** of \$683,000 per year is included to provide ongoing funding for the repair of deteriorating sidewalks for owner-occupied residences. This is a reduction of \$817,000 from the previous forecast to reflect budget actions taken in 2005-2006 that capped the amount of funding the City would contribute for sidewalk repairs. The property owners are responsible for those costs above the cap.

The 2006-2007 forecast **Salary and Benefit Reserve** includes projections for required funding for potential compensation increases for four of the thirteen employee groups open during 2006-2007. In addition, the funding necessary to implement the Police Officers Association's retirement benefit enhancement, discussed previously, has been included here. In the out years of the forecast, the personal services line item includes the estimated impact of prior year negotiated increases and is inflated at a rate considered appropriate to cover likely further negotiated growth.

The **Earmarked Reserves** category includes reserves for support of the California Theater (\$750,000), Fuel (\$500,000), and the Comprehensive General Plan Update (\$200,000). The estimate of \$750,000 in each year of the five-year period includes the amount of funding considered necessary to subsidize the operation of the California Theater by Team San José. Due to the current volatility in the market for fuel, an earmarked reserve for fuel has been included for potential use in 2006-2007. Approximately \$800,000 is needed to fund work as part of a Comprehensive General Plan Update beginning in 2006-2007. Funding for this reserve is being built over a four year period and now totals \$400,000. This reserve is entirely offset by revenues collected from a surcharge on development permits.

**A Vehicle Replacement/General Fleet** allocation of \$1.75 million per year is included to fund a vehicle replacement schedule for the General Fleet. This is a reduction of \$750,000 from the previous forecast to reflect a budget action taken in 2005-2006 on an ongoing basis for the replacement of vehicles in the General Fleet.

In 2006-2007, **Vehicle Replacement/Police Fleet** funding is carried in the departmental budget (\$3.5 million). Due to the large variation in funding levels necessary to fund the replacement of Police vehicles over the five-year period, additional costs ranging from \$2.2 million in 2009-2010 to a reduced need of \$1.8 million in 2008-2009 are shown as a separate line item. This

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Other Expenditures (Cont'd.)

ongoing allocation will ensure that replacement schedules for the marked, covert and unmarked fleet are met.

As in previous years, the **Equipment** category includes a general equipment reserve of \$100,000 for subsequent allocation in the Proposed Budget. Similarly, \$250,000 is assumed annually for computer equipment and automation projects also for subsequent allocation in the Proposed Budget.

### Contingency Reserve

Per Council policy, the 2006-2007 Contingency Reserve is projected at the level necessary to comply with the Council policy to maintain a 3% Contingency Reserve (\$26.0 million). Amounts necessary to remain in compliance with that policy are also included in each of the remaining four years of the forecast.

### Additions to the Base

In this forecast, projected additions to the base expenditure level have been included as a **Committed Addition**. The **Committed Additions** contain expenditures to which the City is considered to be committed by prior Council action and has less discretion, such as the costs related to maintaining and operating capital projects previously approved by City Council. Typically, the forecast Base Case, considered most closely by the City Council, includes ongoing program costs plus committed additions.

In the past, the **Committed Additions** category included only maintenance costs for capital projects. The operating costs for capital projects were included in an Extended Additions category. That presumption has been changed for this forecast. In the Committed Additions category, both the maintenance and operations costs have been included as a more accurate depiction of the full costs of these new facilities.

In prior forecasts, projected additions to the base expenditure level were grouped into two categories: Committed and Extended. The Extended category has been dropped in this forecast. This category previously included ongoing operating costs associated with capital projects that are now being carried as a Committed Addition. The Extended Addition category had also included furnishings, fixtures and equipment (FF&E) costs for capital projects supported by General Obligation Bonds. Because General Obligation Bonds cannot be used for FF&E, these costs had been carried in previous forecasts as a potential General Fund cost. However, alternative funding strategies have been developed or are under development to address these costs using other eligible funding sources.

# ELEMENTS OF THE GENERAL FUND FORECAST

## EXPENDITURE FORECAST (CONT'D.)

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### Additions to the Base (Cont'd.)

The following committed additions are included in the 2007-2011 forecast and explained in more detail in a later section of this document:

A new item to subsidize the operating and debt service costs for the **Hayes Mansion Conference Center** (\$3.9 million) has been included in all five years of the forecast to reflect the latest projected funding gap that exists in the Community Facilities Revenue Fund for debt service payments for the Hayes Mansion Conference Center. This is a new ongoing funding requirement that was not included in the February 2005 forecast.

Increased costs for street lighting and maintenance of scheduled **Street Improvements** (\$172,000 in 2006-2007) are also shown as a Committed Addition.

**New Parks and Recreation Facilities Maintenance** costs (\$985,000 in 2006-2007) are included at the levels necessary to support the additional costs of maintaining new park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies. Additional operating (programming) expenditures are included below.

**New Parks and Recreation Facilities Operations** (\$124,000 in 2006-2007) are included at the levels necessary to support the additional costs of operating new park facilities that were included in the City's latest Five-Year Capital Improvement Program and those that are being developed by other agencies. As discussed previously, this is an ongoing funding requirement that was included in the February 2005 forecast as an Extended not a Committed Addition.

The **Communications Hill Fire Station** is now scheduled to be completed July 2007. In 2006-2007, the forecast includes \$336,000 for start-up costs for a recruitment academy and increases to \$2.3 million in 2007-2008 when the station would be staffed with new fire personnel.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), parks (**Measure P**), police and fire facilities (**Measure O**) and will require additional **Maintenance** funding (\$450,000 in 2006-2007). Additional operating (programming) expenditures are included below.

The approved bond measures from the elections of November 2000 and March 2002 will result in new and expanded library (**Measure O**), parks (**Measure P**), police and fire facilities (**Measure O**) and will require additional **Operations** funding (\$1,944,000 in 2006-2007). As discussed above, this is an ongoing funding requirement that was included in the February 2005 forecast as an Extended and not a Committed Addition.

# ELEMENTS OF THE GENERAL FUND FORECAST

## OPERATING MARGIN

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Base Case expenditures, including committed additions, increase from \$802.8 million in 2006-2007 to \$959.7 million in 2010-2011, for an average growth rate of approximately 4.6%. General Fund sources (including Beginning Fund Balance), on the other hand, total \$766.9 million in 2006-2007, and grow to \$853.2 million in 2010-2011, an average growth rate of only 2.7%.

Compared to the last forecast, produced in February 2005, expected growth rates in the out years of the forecast for expenditures have changed, increasing only slightly from 4.8% to 4.9% for the comparable period of 2007-2008 through 2009-2010. Expectations for overall growth rates for revenue collections during the comparable three-year period have on the other hand decreased slightly from 2.9% to 2.5%.

As discussed above, the updated Base Case with Committed Additions forecast for the General Fund projects a shortfall in the first year (2006-2007) of \$35.9 million. This compares with the last projection for that year released last November of \$76.15 million, and that included in the February 2005 forecast for a \$32.13 million shortfall.

The following table shows how the projected shortfall has changed in the most recent forecasts. The incremental shortfall (assuming each preceding deficit is solved completely with ongoing solutions in the year it appears) for each of the four out years of the forecast is shown below, along with a comparison with the increments projected for those years in the February 2005 forecast and the preliminary 2006-2007 update provided to the City Council in November 2005.

# ELEMENTS OF THE GENERAL FUND FORECAST

## OPERATING MARGIN (CONT'D.)

<b>Base Case with Committed Additions</b> <b>Changes in Operating Margin</b> <b>2007-2011</b> <b>(\$ in Millions)</b>					
	<u>2006-2007</u>	<u>2007-2008</u>	<u>2008-2009</u>	<u>2009-2010</u>	<u>2010-2011</u>
<b>February 2005</b> Incremental Surplus/(Shortfall)	(\$32.13)	(\$30.26)	(\$14.25)	(\$11.35)	N/A
<b>2005-2006</b> <b>Adopted Budget</b> <b>Impact</b> Incremental Surplus/(Shortfall)	(\$31.22)				
<b>Revised Forecast</b>	<b>(\$63.35)</b>	<b>(\$30.26)</b>	<b>(\$14.25)</b>	<b>(\$11.35)</b>	N/A
<b>November 2005</b> Incremental Surplus/Shortfall	<b>(\$76.15)</b>	N/A	N/A	N/A	N/A
<b>February 2006</b> Incremental Surplus/Shortfall	<b>(\$35.89)</b>	(\$39.02)	(\$11.44)	(\$15.24)	(\$4.93)

In the February 2005 forecast, an incremental shortfall of \$32.13 million for 2006-2007 was projected. This figure was based on the assumption that the entire 2005-2006 shortfall would be solved with ongoing actions. However, the 2005-2006 Adopted Budget included a combination of ongoing and one-time solutions. The carryover impact of those one-time measures is reflected in the 2005-2006 Adopted Budget Impact incremental shortfall of \$31.2 million and when combined with the previous shortfall anticipated for 2006-2007 would result in a deficit of approximately \$63.35 million in 2006-2007.

In November 2005, a preliminary review of anticipated revenues and expenditures for 2006-2007 was completed that resulted in a revised shortfall figure of \$76 million. The \$12.8 million increase from the shortfall figure estimated when the 2005-2006 Adopted Budget was developed primarily reflects the net impact of additional revenue estimates for Property and Utility Taxes (\$16.3 million) offset by revised compensation increases for public safety sworn employees



## ELEMENTS OF THE GENERAL FUND FORECAST

### OPERATING MARGIN (CONT'D.)

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(\$16.7 million) and proposed increase to the employer contribution rate to the Federated Retirement Plan (\$10.0 million).

For the February 2006 forecast, Staff completed an in-depth review of anticipated revenues and expenditures for 2006-2007 and the remaining four years of the forecast period. Based on this updated information, a General Fund shortfall for 2006-2007 in the amount of \$35.9 million is projected, a net decrease of \$40.2 million from the November 2005 figure. This significant reduction results from the combined impact of Additional Beginning Fund Balance of \$15.0 million and approved employer contribution rates for both Federated and Police/Fire Retirement Plans (\$25.9 million) offset by a delay in the projected proceeds from the Sale of the Employee Parking Lot of the old City Hall (\$12.5 million) and inclusion of funding of \$3.9 million to subsidize the costs of operations and debt service costs for the Hayes Mansion Conference Center.

In the out years of the forecast, incremental shortfalls ranging from \$4.9 million to \$39.0 million annually are projected. The persistent shortfalls reflect the fact that revenue growth is projected to lag behind the growth in expenditures.

### One-Time Funding Available

Not included in the forecast but available for Council consideration are a number of one-time funding sources. Per City Council policy, a **Future Deficit Reserve** (\$18.4 million) was established as part of the 2004-2005 Annual Report (\$12.4 million) and Mid-Year Budget Review (\$6.0 million) actions. This reserve was set aside to fund a portion of the shortfall that was projected for 2006-2007 February 2005 forecast. This reserve is not assumed in the remaining forecast years. However, the amount of funding that has been set aside historically for future year deficits has ranged from \$12.4 million in 2004-2005 to a low of \$4.3 million in 2000-2001. Per City Council policy, any remaining unallocated funds available at the close of each fiscal year are directed to be used to cover any projected shortfall in the following year based on the Five-Year Forecast. Also included in this category is a reserve of \$9.5 million available from the Council directed phase-out of **Cardroom Revenues** from the ongoing budget. The cumulative total of these one-time funding sources is \$27.9 million in 2006-2007. In addition, in 2007-2008, \$12.5 million has been included to reflect a portion of the proceeds from the **Sale of the Employee Parking Lot** (E-lot) from the old City Hall that could be utilized in 2007-2008 if the sale of the property is completed as currently contemplated.